Module 11 - Earned Income Credit

Tax Tutorial

In this tax tutorial, you will learn about the Earned Income Credit. A tax credit is a dollar-for-dollar reduction of the tax.

The earned income credit is a tax credit for certain people who work and whose earned income and adjusted gross income are under a specified limit.
For 2007, the earned income and adjusted gross income limits are
• $37,783 ($39,783 if married filing jointly) and more than one qualifying child.
• $33,241 ($35,241 if married filing jointly) and one qualifying child.
• $12,590 ($14,590 if married filing jointly) and no qualifying child.

There are many rules that apply to the earned income credit.

At the same adjusted gross income level, taxpayers
• filing a joint return with two or more qualifying children receive the highest earned income credit.
• not filing a joint return if a qualifying child receive the lowest earned income credit.
Eligible taxpayers can receive the earned income credit even if their tax is zero.

next

Module 11 - Earned Income Credit

Tax Deduction vs. Tax Credit

Tax Deduction

A tax deduction reduces income subject to tax.

For each dollar of tax deduction, the reduction in tax liability is less than a dollar.

Assume that the tax rate is 15 percent and the tax deduction is $200.

The Effect of Deductions on Income Subject to Tax

	Without Deduction	With Deduction
Income Subject to Tax	$10,000	$9,800
Tax at 15%	$1,500	$1,470

At a 15 percent tax rate, a $200 **tax deduction** results in a $30 reduction in the tax.

Tax Credit

A tax credit is a dollar-for-dollar reduction in the tax liability.

For each dollar of tax credit, there is a dollar reduction in the tax liability.

Continuing with the example, assume that the tax credit is $200.

The Effect of Deductions and Credits on Income Subject to Tax

	Without Deduction With Credit	With Deduction Without Credit
Tax	$1,500	$1,470

Tax Credit	-(200)	0
Total Tax	$1,300	$1,470

A $200 **tax credit** results in a $200 reduction in the tax liability. This is a dollar-for-dollar reduction in the tax liability.

With a $200 **tax deduction**, the total tax is $1,470.
With a $200 **tax credit**, the total tax is $1,300.
The taxpayer pays less tax with a $200 tax credit than with a $200 tax deduction.

previous next

Module 11 - Earned Income Credit

The earned income credit is a tax credit for certain people who work and have earned income and adjusted gross income under a specified limit.

For 2007, the earned income and adjusted gross income limits are

- $37,783 ($39,783 if married filing jointly) and more than one qualifying child.
- $33,241 ($35,241 if married filing jointly) and one qualifying child.
- $12,590 ($14,590 if married filing jointly) and no qualifying child.

This credit is called the "earned income" credit because to qualify, you must work and have earned income. Earned income includes wages, salaries, and tips that are includible in gross income and net earnings from self-employment earnings.

Many rules apply to the earned income credit.

Be patient as you learn about the requirements to claim the credit.

previous next

Module 11 - Earned Income Credit

Rules for Everyone

To claim the earned income credit, taxpayers must meet all eight of the following rules:

1. Earned income and adjusted gross income must be less than:
    - $37,783 ($39,783 if married filing jointly) and more than one qualifying child.
    - $33,241 ($35,241 if married filing jointly) and one qualifying child.
    - $12,590 ($14,590 if married filing jointly) and no qualifying child.
2. Must have a valid social security number issued by the Social Security Administration.
3. Cannot use the married filing a separate return filing status.
4. Must be a U.S. citizen or resident alien all year. (Exception for married nonresident alien who chooses to be treated as a resident alien).
5. Cannot file Form 2555 or Form 2555-EZ to exclude income earned in foreign countries.
6. Investment income must be $2,900 or less. Investment income includes taxable and tax-exempt interest, dividends, capital gain net income, certain rental and royalty income, and net passive activity income.
7. You must have earned income.
8. Cannot be the qualifying child of another person.

previous next

Module 11 - Earned Income Credit

Quick Check!

Answer the following multiple-choice questions about the earned income tax credit by clicking on the correct answers. To assess your answers, click the *Check My Answers* button at the bottom of the page.

1) The contrast between a tax deduction and a tax credit is that

A. a tax deduction is more beneficial than a tax credit for the same amount. No answer given: the correct answer is B. A tax credit is a dollar-for-dollar reduction of the tax. A tax deduction reduces income subject to tax.

B. a tax credit is more beneficial than a tax deduction for the same amount.

C. a tax credit reduces income subject to tax.

D. a tax deduction is a dollar-for-dollar reduction of the tax.

2) Which of the following is an example of earned income?

A. interest income No answer given: the correct answer is C. Earned income includes wages, salaries, tips, and self-employment earnings. Interest income, dividend income, and capital gains distributions are not considered earned income.

B. dividend income

C. salaries

D. capital gain distributions

3) Assuming that all other rules are met, which taxpayer cannot claim the earned income tax credit?

A. Jolene is married and files a joint return. No answer given: the correct answer is B. If all other rules are met, taxpayers who use the married filing a joint return can claim the Earned Income Credit. Tips are considered earned income.

B. All of Allen's income is from interest and dividends.

C. Celina is a citizen of Mexico but was a resident of the United States during the entire tax year.

D. Most of Jim's income comes from tips.

previous

next

Module 11 - Earned Income Credit

Rules for Determining Who Is a Qualifying Child

To be a qualifying child, the child must meet the relationship, age, and residency tests. Unless those tests are met, the child is not a qualifying child.

Relationship Test

To meet the relationship test, the child must be the taxpayer's

• son, daughter, adopted child, stepchild, or a descendant of any of them (for example, your grandchild).

• brother, sister, stepbrother, half brother, half sister, stepsister, or a descendant of any of them (for example, your niece or nephew).

• eligible foster child placed with the taxpayer by an authorized agency, whom the taxpayer cares for as the taxpayer's own child.

• an adopted child and a child placed with the taxpayer for adoption is treated as a biological child.

Age Test

To meet the age test, the child must be

• under age 19 at the end of the tax year,

• under age 24 at the end of the tax year and a full-time student. Remember, the child need not be a full-time student at the end of the tax year, merely for any 5 months during the tax year,

• permanently and totally disabled at any time during the tax year, regardless of age.

Residency Test

To meet the residency test, the child must have lived with the taxpayer in the United States for more than half of the tax year.

previous next

Module 11 - Earned Income Credit

Rules for Taxpayers with a Qualifying Child

Sometimes a child meets the rules to be a qualifying child of more than one person.

However, only one person can treat that child as a qualifying child and claim the EIC using that child.

If two or more taxpayers have the same qualifying child, they can choose which of them will claim the credit using that child. If more than one taxpayer actually claims the credit using the same child, the IRS will apply the tie-breaker rules.

When More Than One Person Claims EIC Using Same Child (Tie-Breaker Rule.)	
IF more than one person claims the EIC using the same child and	**THEN . . . .**
Only one of the persons is the child's parent	Only the parent can treat the child as a qualifying child.
Two of the persons are the child's parent, and they do not file a joint return together	Only the parent with whom the child lived the longest during the year can treat the child as a qualifying child.
Two of the persons are the child's parent, the child lived with each parent the same amount of time during the year, and the parents do not file a joint return together	Only the parent with the highest adjusted gross income (AGI) can treat the child as a qualifying child.

None of the persons are the child's parent	Only the person with the highest AGI can treat the child as a qualifying child.

previous next

Module 11 - Earned Income Credit

Quick Check!

Answer the following questions about the earned income credit by clicking on the correct answers. To assess your answers, click the *Check My Answers* button at the bottom of the page.

1) Alicia and her youngest sister live alone together, and Alicia cares for her youngest sister as her own child. Assuming that the other rules are met, can Alicia's sister be considered a qualifying child?

A. Yes No answer given: The correct answer is A. A sister is a qualifying child.

B. No

2) After his father died in March, Joseph (age 18) moved in with his cousin. His cousin cares for Joseph as his own child. Assuming that the other rules are met, can Joseph be considered a qualifying child?

A. Yes No answer given: The correct answer is B. A cousin does not meet the relationship test. Joseph is not a foster child because he was not placed with his cousin by an authorized placement agency.

B. No

3) William turned 19 on December 4 and is not a student or disabled. Assuming that the other rules are met, can William be considered a qualifying child?

A. Yes No answer given: The correct answer is B. William was not under age 19 at the end of the tax year.

B. No

4) The state placed Simone with the taxpayer in October. The taxpayer cares for Simone as the taxpayer cares for her own children. Can the taxpayer claim Simone as a qualifying child?

A. Yes No answer given: The correct answer is B. Simone did not live with the taxpayer for more than half of the tax year.

B. No

5) LeeAnn's daughter and grandson live with her. The daughter is 25 years old. The grandson is 5 years old. LeeAnn earns $15,000 from her job. Her daughter

earns $7,000 from her job. Because he meets the relationship, age, and residency tests, the child is a qualifying child of both LeeAnn and her daughter. Who can claim the child as a qualifying child if there is a disagreement, LeeAnn or LeeAnn's daughter?

A. LeeAnn No answer given: The correct answer is B. If the child could be considered a qualifying child by more than one taxpayer and one taxpayer is the child's parent, the child's parent is the only one who can claim the child as a qualifying child and receive the credit.

B. LeeAnn's daughter

Module 11 - Earned Income Credit

Rules for Taxpayers without a Qualifying Child

To claim the earned income credit, a taxpayer without a qualifying child

- must be at least age 25 but under age 65,
- cannot be a dependent of another person,
- cannot be a qualifying child of another person, and
- must have lived in the United States for more than half of the year.

previous next

Module 11 - Earned Income Credit

The earned income credit is determined by the taxpayer's earned income and adjusted gross income.

To claim the earned income credit in 2007, the taxpayer's earned income and adjusted gross income must be less than

• $37,783 ($39,783 if married filing jointly) and more than one qualifying child.

• $33,241 ($35,241 if married filing jointly) and one qualifying child.

• $12,590 ($14,590 if married filing jointly) and no qualifying child.

If adjusted gross income is the same, taxpayers

• filing a joint return with more than one qualifying child receive the highest earned income credit.

• filing a joint return with one qualifying child receive the next highest earned income credit.

• not filing a joint return who do not have a qualifying child receive the lowest earned income credit.

Remember: The earned income credit is a dollar-for-dollar reduction of the tax. Eligible taxpayers can receive the earned income credit even if their tax is zero.

previous next

Module 11 - Earned Income Credit

Quick Check!

Indicate whether each of the statements below is true or false by clicking on the correct answer. To assess your answers, click the *Check My Answers* button at the bottom of the page.

1) Taxpayers must have a qualifying child to claim the earned income credit

A. True No answer given: the correct answer is B. If the taxpayer meets all of the other rules, a taxpayer without a qualifying child can claim the Earned Income Credit.

B. False

2) Jeremy is 67 years old. He doesn't have a qualifying child. His income is $6,300. He meets the other earned income credit requirements. Jeremy can claim the earned income credit.

A. True No answer given: the correct answer is B. Jeremy cannot claim the Earned Income Credit because he is not under age 65.

B. False

3) For the earned income credit, earned income and the adjusted gross income limit is higher for taxpayers with two or more qualifying children.

A. True No answer given: the correct answer is A. In 2007, the earned income and adjusted gross income limit is $37,783 ($39,783 if filing a joint return) for taxpayers with more than one qualifying child and $33,241 ($35,241 if filing a joint return) for taxpayers with one qualifying child.

B. False

previous next

Module 11 - Earned Income Credit

Example

Earl and Waltina Perry both have jobs. They have two children, Janelle and Jason, who meet the relationship, age, and residency tests. Both were under age 19 at the end of 2007. Earl and Waltina file a joint tax return. They are eligible to claim the earned income credit. Review Schedule EIC for the Perrys.

SCHEDULE EIC
(Form 1040A or 1040)
Department of the Treasury Internal Revenue Service (99)

Earned Income Credit
Qualifying Child Information

Complete and attach to Form 1040A or 1040 only if you have a qualifying child.

1040A 1040 EIC

OMB No. 1545-0074
2007
Attachment Sequence No. 43

Name(s) shown on return | Your social security number

Before you begin: See the instructions for Form 1040A, lines 40a and 40b, or Form 1040, lines 66a and 66b, to make sure that (a) you can take the EIC, and (b) you have a qualifying child.

CAUTION

- If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See back of schedule for details.
- It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child.
- Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

Qualifying Child Information	Child 1	Child 2
1 Child's name If you have more than two qualifying children, you only have to list two to get the maximum credit.	First name / Last name: Janelle Perry	First name / Last name: Jason Perry
2 Child's SSN The child must have an SSN as defined on page 43 of the Form 1040A instructions or page 49 of the Form 1040 instructions unless the child was born and died in 2007. If your child was born and died in 2007 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate.	123 45 6789	123 45 6788
3 Child's year of birth	Year 1 9 9 8 *If born after 1988, skip lines 4a and 4b; go to line 5.*	Year 2 0 0 0 *If born after 1988, skip lines 4a and 4b; go to line 5.*
4 If the child was born before 1989— a Was the child under age 24 at the end of 2007 and a student?	☐ Yes. *Go to line 5.* ☐ No. *Continue.*	☐ Yes. *Go to line 5.* ☐ No. *Continue.*
b Was the child permanently and totally disabled during any part of 2007?	☐ Yes. *Continue.* ☐ No. The child is not a qualifying child.	☐ Yes. *Continue.* ☐ No. The child is not a qualifying child.
5 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, foster child, etc.)	daughter	son
6 Number of months child lived with you in the United States during 2007 • If the child lived with you for more than half of 2007 but less than 7 months, enter "7." • If the child was born or died in 2007 and your home was the child's home for the entire time he or she was alive during 2007, enter "12."	12 months *Do not enter more than 12 months.*	12 months *Do not enter more than 12 months.*

TIP You may also be able to take the additional child tax credit if your child (a) was under age 17 at the end of 2007, and (b) is a U.S. citizen or resident alien. For more details, see the instructions for line 41 of Form 1040A or line 68 of Form 1040.

For Paperwork Reduction Act Notice, see Form 1040A or 1040 instructions. Cat. No. 13339M Schedule EIC (Form 1040A or 1040) 2007

Review page two of Form 1040 for the Perrys. Their tax is $730. The federal income tax withheld is $1,010. The earned income credit is shown on line 66a. The Perrys have a refund of $2,031. $1,751 of the refund is a result of the earned income credit.

Other Taxes	58	Self-employment tax. Attach Schedule SE			58	
	59	Unreported social security and Medicare tax from: a ☐ Form 4137 b ☐ Form 8919			59	
	60	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required			60	
	61	Advance earned income credit payments from Form(s) W-2, box 9			61	
	62	Household employment taxes. Attach Schedule H			62	
	63	Add lines 57 through 62. This is your total tax ▶			63	730 00
Payments	64	Federal income tax withheld from Forms W-2 and 1099	64	1,010 00		
	65	2007 estimated tax payments and amount applied from 2006 return	65			
If you have a qualifying child, attach Schedule EIC.	66a	Earned income credit (EIC)	66a	1,751 00		
	b	Nontaxable combat pay election ▶ 66b				
	67	Excess social security and tier 1 RRTA tax withheld (see page 60)	67			
	68	Additional child tax credit. Attach Form 8812	68			
	69	Amount paid with request for extension to file (see page 60)	69			
	70	Payments from: a ☐ Form 2439 b ☐ Form 4136 c ☐ Form 8885	70			
	71	Refundable credit for prior year minimum tax from Form 8801, line 27	71			
	72	Add lines 64, 65, 66a, and 67 through 71. These are your total payments ▶			72	2,761 00
Refund	73	If line 72 is more than line 63, subtract line 63 from line 72. This is the amount you overpaid			73	
Direct deposit? See page 61 and fill in 74b, 74c, and 74d, or Form 8888.	74a	Amount of line 73 you want refunded to you. If Form 8888 is attached, check here ▶ ☐			74a	2,031 00
	▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings				
	▶ d	Account number				
	75	Amount of line 73 you want applied to your 2008 estimated tax ▶	75			
Amount You Owe	76	Amount you owe. Subtract line 72 from line 63. For details on how to pay, see page 62 ▶			76	
	77	Estimated tax penalty (see page 62)	77			

◀ previous next ▶

Module 11 - Earned Income Credit

Lesson Summary

A tax credit is a dollar-for-dollar reduction of the tax.

The earned income credit is a refundable tax credit for certain people who work and whose earned income and adjusted gross income is under a specified limit.

• For 2007, these limits are:

• $37,783 ($39,783 if married filing jointly) and more than one qualifying child.

• $33,241 ($35,241 if married filing jointly) and one qualifying child.

• $12,590 ($14,590 if married filing jointly) and no qualifying child.

There are many rules that apply to the earned income credit.

At the same adjusted gross income level, taxpayers

• who file a joint return and have two or more qualifying children receive the highest earned income credit.

• who do not file a joint return and do not have a qualifying child receive the lowest earned income credit.

Taxpayers who are eligible can receive the earned income credit even if their tax is zero.

previous

Module 11 - Glossary

Glossary

earned income —includes wages, salaries, tips, and self-employment earnings.

qualifying child —a qualifying child for the earned income credit meets the relationship, age, and residency tests. A taxpayer who claims the earned income credit cannot be the qualifying child of another person. A person can be claimed as a qualifying child on one tax return only.

adjusted gross income —total income reduced by certain amounts, such as for an IRA or student loan interest

Earned Income Credit —a credit that can be paid to low-income workers, even if no income tax was withheld from the workers' pay. To receive the credit, a taxpayer must file a tax return.

previous